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ASCSP Comments on AmeriSouth XXXII., Tax Court Memo 2012-67©

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Summary
In the recently released AmeriSouth XXXII., Tax Court Memo 2012-67, the IRS makes its first meaningful strike in its attempt to marginalize the benefits of cost segregation studies for residential rental property. For many taxpayers and CPAs, this is a complete surprise. However, ASCSP members have known for over a year that this was likely to happen. The IRS seems to have made a coordinated national effort with regards to the classification of assets in residential rental property. Although there are currently numerous IRS exams underway involving depreciation of apartments, the IRS had yet to establish formal case law directly on point with its position on apartments. Further, the IRS warned cost segregation professionals of this position at an ASCSP National Conference and indicated they were going to release a Cost Segregation Industry Directive specific to the residential rental industry. This Directive has yet to be published. ASCSP believes that, much like early case law from the Investment Tax Credit era, just because this specific Tax Court Memo was unfavorable, it does not mean future tax court rulings on the same issues will be consistent. ASCSP provides its opinions below on several items disputed in this case. Further, this case emphasizes the importance of using a Certified or Senior Member of the American Society of Cost Segregation Professionals to ensure the taxpayer is aware of all current industry developments.

Facts:
AmeriSouth XXXII, Ltd. acquired an apartment complex in 2003 for $10.25 million. The property was originally built in 1970. As soon as AmeriSouth bought the property, it began a $2 million renovation of the apartments that included replacing cabinets and countertops, dishwashers, garbage disposals, vent hoods, and kitchen sinks. The cost segregation study results were reported on the originally filed tax return for 2003. Roughly 33% of the property was reclassified into categories with 5 or 15 year tax lives. The components at issue include:

site preparation and earthwork	**special plumbing**
water-distribution system	**special electric**
sanitary-sewer system	**finish carpentry**
gas line	**Millwork**
site electric	**interior windows and mirrors**
special HVAC	**special painting**

AmeriSouth sold the property about the time the case was tried, and stopped responding to communications from the Court, the Commissioner, and even its own counsel. Because of AmeriSouth's lack of responsiveness, their lawyers withdrew from the case and left the taxpayer representing itself. ***The case could have been dismissed entirely, but because AmeriSouth didn't file a post trial brief, the Court deemed any factual matters not otherwise contested to be conceded.***

ASCSP Commentary:
ASCSP understands that some of positions taken in this cost segregation study are considered somewhat aggressive by most experts. Based on the TC Memo, it also appears there was poor reference material available to substantiate the asset classifications used. A critical factor in this case was that the taxpayer had no interest in defending themselves, effectively giving the IRS a free pass to present their position on many issues without being challenged. In essence, this is the perfect storm for the multi-family industry caused in part by a taxpayer who didn't resolve the issues at appeals and then essentially gave up when the case went to tax court. It is important to note

that this was a Tax Court Memo, and is technically not authority, but that will not prevent the IRS from referencing this during future exams of a cost segregation studies.

We believe one of the most significant issues contested and considered by the Court relates to the appropriate comparison benchmark for an apartment. Should the Court look to see if the items in question relate to the operation and maintenance of a typical apartment building, or to the operation and maintenance of a generic shell building? The Court rationalized that the type of building *does* matter. ASCSP does not agree with the Court in this critical decision. While it is true that residential rental property enjoys a 27.5 year life versus 39 years for non-residential real property, the leap from building to apartment building seems to be a stretch and we are not convinced that the commissioner would have been successful if the argument had been opposed. We note if this principle is applied to a 15 year service station (asset class 57.1), it would conflict with existing case law that supports personal property classification in service stations. The same can be said for 20 year farm buildings and 15 year restaurant property. Nonetheless, if this argument holds up in future cases, it could have widespread consequences. Below are ASCSP's comments specific to items held to be real property by the Court.

Site Utilities – Denied as 15 year property. Site utilities are outlined in several previously issued IRS Directives as 1250 Real Property when they relate to a typical building, and we agree. While ASCSP understands methodical allocations of site utilities may be appropriate in some cases, it is hard to argue an apartment building's gas, water, sewer, and electric service does not relate to the overall operation and maintenance of a building as described in the definition of a structural component found in §1.48-1(e)(2).

Special HVAC – Partially denied as 5 year property. The venting connected to the stove hoods was not allowed because the Court was not convinced that they serve only the stoves. They rationalized that the stove hoods can also serve to remove odors and heat from beyond the stovetop. ASCSP disagrees and believes that if proper case law was referenced, the Court would have allowed these items as 5 year property. Serving as ventilation for the building is merely incidental to its primary function of servicing the stove. Venting serving the dryer was allowed as personal property.

Special Plumbing - Denied as 5 year property. Interestingly, the tax Court considered that AmeriSouth did not intend to periodically replace or plan to replace sinks after the 2003 renovation. While the intent to replace an item is relevant for purposes of determining Repair vs. Capitalization, it generally is not considered when determining the appropriate tax life of an asset. ASCSP also notes that the Court cited the accessory test early in this case but failed to apply such test to any of the items in question. One can argue that kitchen sinks and plumbing are accessory to and necessary for the business of renting apartments.

Ceiling fans and Lights – Denied as 5 year property. ASCSP believes this would have been ruled 5 year tangible personal property if AmeriSouth argued that the lighting provided by these combination light-fans serves to provide ambiance and only incidentally serves as general lighting. The fans are not structural components to the property.

Wiring – Denied as 5 year property. ASCSP believes this also would have been ruled 5 year tangible personal property if AmeriSouth showed that the wiring supplied power for the appliances. The Court stated there was no evidence showing such.

Electric Panels – Denied as 5 year property. Quite simply, if a proper electrical load calculation was conducted and documented between specific equipment and the overall requirements of the building, ASCSP believes this item would have been ruled 5 year tangible personal property. This has been proven in the Scott Paper case.

Millwork and Finish Carpentry - Denied as 5 year property. The Court stated that the proper classification of the cabinetry is strictly an issue of their permanence and implied the same for the finish carpentry. ASCSP has obtained information from unpublished resources that the general contractor who testified was not prepared to explain the steps required to remove these items and not prepared to address the six Whiteco Factors. ASCSP believes the Court would have a different opinion if the permanence of these items was explained by the taxpayer in the context of the Whiteco Case. The vast majority of all kitchen cabinetry in modern apartments is easily removable and reusable.

Mirrors – Denied as 5 year property. ASCSP believes if proper case law was referenced, the Court would have allowed these items as tangible personal property. The Court did not dispute that the mirrors are removable. However, when AmeriSouth's former attorney called for testimony that the mirrors were decorative, their own witness stated the dining-room mirrors had "no function," which actually supports the IRS position. I wonder if the judge scratched his head at this point in confusion and wondered which side this witness was arguing for.

Closing:
The story of this case is that poor preparation and documentation allowed the IRS to get their positions on the record with circumstances that favored them before the case even started. Unfortunately, according to our inside member resources this case will not be appealed as the taxpayer has no interest in the property anymore. This case emphasizes the risks of not using a Certified or Senior member of ASCSP to conduct these studies. Before choosing one provider over another, check their credentials at www.ascsp.org.

A fellow ASCSP member is in the process of assisting another tax payer/apartment owner that expects to be taking the same issues to tax court. We believe the outcome of that case will be much more relevant to the issues at hand. We will be closely monitoring developments in this area. If you are a taxpayer/owner of apartments and would like to discuss these issues further, please contact a member of the ASCSP. ASCSP is committed to supporting taxpayers that are willing to bring this issue to tax court.